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Report to the Subcommittee on  
Readiness and Management Support,  
Committee on Armed Services, U.S.  
Senate

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April 2002

# DEFENSE ACQUISITIONS

## Status of Defense Logistics Agency's Efforts to Address Spare Part Price Increases



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<b>Abstract</b> In recent years, the Department of Defense (DOD) has experienced significant increases in the prices it pays for some spare parts particularly consumable spare parts. These are parts that are consumed when used or discarded when worn out because they cannot be cost-effectively repaired. The Defense Logistics Agency (DLA) manages about 4 million consumable spare parts and provides about 93 percent of all consumable spare parts used by the military services. The military services have also expressed concerns to the Congress that spare part prices have been increasing at a higher rate than inflation and have taken an unanticipated bite out of the limited funds available to meet readiness requirements. In response to these problems, section 803(c) of the Strom Thurmond National Defense Authorization Act for Fiscal Year 1999 (P.L. 105-261)1 required DOD to perform price trend analyses on certain categories of commercial spare parts, address unreasonable price escalation, and annually report the results to the Congress for 3 consecutive years starting by April 2000.	
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United States General Accounting Office  
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April 8, 2002

The Honorable Daniel K. Akaka  
Chairman  
The Honorable James M. Inhofe  
Ranking Minority Member  
Subcommittee on Readiness and Management Support  
Committee on Armed Services  
United States Senate

In recent years, the Department of Defense (DOD) has experienced significant increases in the prices it pays for some spare parts—particularly consumable spare parts. These are parts that are consumed when used or discarded when worn out because they cannot be cost-effectively repaired. The Defense Logistics Agency (DLA) manages about 4 million consumable spare parts and provides about 93 percent of all consumable spare parts used by the military services. The military services have also expressed concerns to the Congress that spare part prices have been increasing at a higher rate than inflation and have taken an unanticipated bite out of the limited funds available to meet readiness requirements. In response to these problems, section 803(c) of the Strom Thurmond National Defense Authorization Act for Fiscal Year 1999 (P.L. 105-261)<sup>1</sup> required DOD to perform price trend analyses on certain categories of commercial spare parts, address unreasonable price escalation, and annually report the results to the Congress for 3 consecutive years starting by April 2000.

As requested, we evaluated the status of DLA's efforts to address problems related to spare part price increases.

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## Results in Brief

DLA has undertaken a range of efforts to respond to concerns about significant spare part price increases. These efforts, however, are in various stages of completion and it is too early to assess the results.

In response to the 1999 Defense Authorization Act, DLA has completed two price trend analyses of commercial spare parts for DOD. Most recently, DLA reported in March 2001 that from fiscal years 1993 through

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<sup>1</sup> 10 U.S.C. 2306a note.

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2000 its materiel cost grew 10.8 percent for competitively purchased commercial items and 23.8 percent for noncompetitive purchases of commercial items. DLA is examining the causes for these different increases and plans to provide more detailed explanations of cost growth disparities and any remedies in its third and final report to DOD.

In addition to the price trend analyses, DLA conducted a procurement management review (PMR)<sup>2</sup> at its hardware centers in fiscal year 2000 to specifically assess the overall risk of spare part overpricing. As a result of this PMR and other risk assessments, DLA summarized 17 lessons learned regarding price reasonableness determinations to help minimize risk. Another PMR in fiscal year 2001 found that pricing of first-time buys was a significant risk to DLA and a weakness at all three of its hardware centers.

DLA also has three information technology initiatives underway aimed at providing DLA customers and buyers better information for determining price reasonableness. One initiative involves modifying the computerized Federal Catalog System to alert customers when spare part prices are estimates or out of date. DLA is also developing two computer programs designed to help its buyers determine price reasonableness of an item they are considering for purchase by using pricing information from prior purchases of similar items.

Because DLA's initiatives are in various stages of completion, we are not making recommendations in this report. In commenting on our draft, DOD agreed with our findings.

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## Background

Price increases for consumable spare parts have been a persistent concern within DOD, namely because DLA customers are often unaware of such increases until they actually purchase a part. Both GAO and the DOD Inspector General (IG) have evaluated this problem and found systemic weaknesses in the pricing of spare parts. In November 2000,<sup>3</sup> for example, we reported that a small, but steadily growing, number of DLA-managed consumable spare parts experienced significant annual price increases, principally due to inaccurate price estimates, long periods of time between

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<sup>2</sup> A PMR is an internal review and assessment of procurement policies, procedures, and operations at selected DLA locations.

<sup>3</sup> U.S. General Accounting Office, *Defense Acquisitions: Price Trends for Defense Logistics Agency's Weapon System Parts*, GAO-01-22 (Washington D.C.: Nov. 3, 2000).

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procurements, and changes in procurement quantities. In July 2000,<sup>4</sup> we reported that spare parts managed by the Marine Corps incurred significantly higher price increases than similar items sold in the private sector. Likewise, spare part pricing has been the subject of several DOD IG reports. For example, a May 2001 report stated that price analysis documentation maintained by contracting officers was often inadequate to support price reasonableness determinations when purchasing spare parts.<sup>5</sup>

Also concerned about price increases, the Congress, through section 803 of the 1999 Defense Authorization Act, required DOD to improve the way it manages pricing of certain commercial spare parts. Among other things, DOD was required to collect and analyze information on price trends and take appropriate action to address any unreasonable escalation in prices being paid for these items. The Congress intended for DOD to establish a system for tracking price trends in spare parts in order to isolate categories of items that require further management attention. As a result, DOD directed DLA and the military services to conduct price trend analyses and provide reports to a DOD working group tasked to assemble the results of the price trend analyses. Section 803 also required DOD to submit three annual reports on its findings to the House and Senate Committees on Armed Services. The reports were due by April 1 of 2000, 2001, and 2002.

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## DLA's Efforts to Address Spare Part Price Increases

DLA has taken a number of steps to improve its management of spare part prices. These include detailed analyses of price increases, management reviews to address the risk of overpricing, and information technology initiatives aimed at helping DLA buyers determine price reasonableness and better alerting customers to possible price increases.

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<sup>4</sup> U.S. General Accounting Office, *Defense Acquisitions: Prices of Marine Corps Spare Parts Have Increased*, GAO-00-123 (Washington, D.C.: July 31, 2000).

<sup>5</sup> Office of the Inspector General, Department of Defense, *Contracting Officer Determinations of Price Reasonableness When Cost or Pricing Data Were Not Obtained*, Report No. D-2001-129 (May 30, 2001).

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## Price Trend Analyses Showed Cost Growth Significantly Higher for Noncompetitive Purchases

To satisfy the requirement of section 803(c) of the 1999 Defense Authorization Act, DOD submitted two reports to the Armed Services Committees—the first in April 2000 and the second in June 2001. Although the DOD reports also included information from the military services, DLA performed most of the price trend analysis. Our assessment centered on DLA's price trend analysis reports.

DLA reports showed that materiel cost growth for noncompetitive items was significantly higher than for competitive items. In its March 2001 report, DLA analyzed data for commercial items purchased in fiscal years 1996 through 1998 and compared the average cost growth rate for fiscal years 1993 through 2000. The cumulative growth rate was 23.8 percent for the noncompetitive items, compared to 10.8 percent for competitive items. Previously, in March 2000, DLA reported an increase for fiscal years 1993 through 1999 of 23 percent for noncompetitive items exceeding \$500,000 and 12.3 percent for all commercial items. In both reports, DLA noted that the overall cumulative growth rate fell between the Producer Price Index and the Consumer Price Index during the same study periods.

DLA is still working to identify the causes of the varying growth rates. To help in this effort, DLA established a team that will examine price trends for a randomly selected sample of noncompetitive commercial items. This should enable DLA to identify anomalies and patterns of excessive price growth for individual items and suppliers. The primary effort of DLA's third year study will be aimed at further examining price trends for noncompetitive and competitive commercial items. DLA plans to examine the causes of these different increases and to provide more detailed explanations of cost growth disparities and any remedies in its final report.

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## Procurement Management Reviews Conducted to Help Minimize Risk of Overpricing

DLA conducted PMRs to identify actions that can be taken to minimize the risk of overpricing. These reviews entailed assessing an organization's policies, procedures, business processes, and management information tools with the aim of identifying root causes to problems and practical solutions.

In April 2000, DLA issued a PMR report that specifically assessed the risk of spare part overpricing at its three hardware centers.<sup>6</sup> This report

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<sup>6</sup> DLA's three hardware centers are located in Philadelphia, Pennsylvania; Columbus, Ohio; and Richmond, Virginia.

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addressed five categories of potentially overpriced acquisitions.<sup>7</sup> The results of this PMR, and other risk assessments performed by DLA in response to several DOD IG reports, were summarized in a memorandum to DLA buying center commanders as 17 lessons learned that should help mitigate the risk of overpricing. For example, two of these lessons learned suggested that buyers would increase their leverage in the marketplace, and help ensure that fair and reasonable prices were obtained, by involving experts in a variety of disciplines. These experts included designated cost/price analysts, personnel from the Defense Contract Management Agency and the Defense Contract Audit Agency, and functional experts such as market analysts and supply analysts. Further, continuous improvement in the area of contract pricing was stated as being critical to meeting the current needs of DLA customers as well as to the success in shifting to commercial practices.

In September 2001, DLA issued another PMR report citing that a significant risk to DLA, and a weakness at all three hardware centers, was the pricing of DLA first-time buys—which typically have no pricing history available. First-time buys represent only a small portion of buys made by hardware centers. Nonetheless, pricing of first-time buys is particularly important in DLA’s efforts to mitigate the risk of overpricing because the unit price on first-time buys frequently becomes the baseline for pricing future acquisitions of the item. The review showed that only 31 percent of the first-time buys at the three centers were appropriately determined to be either fair and reasonable or properly documented as not fair and reasonable. As a result, DLA management classified pricing of first-time buys as a material weakness at one center and a management concern at the other two centers.

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### Technology Initiatives to Provide Improved Pricing Information to Buyers

DLA has a number of technology initiatives intended to help buyers determine price reasonableness, especially in cases of first-time buys, or long periods between buys. In June 2002, DLA expects to implement a modification to the Federal Catalog System, adding two new data fields to alert buyers from the military services of possible price changes and hopefully, reduce “sticker shock.” One field will identify whether the listed price for an item is an actual price paid or an estimated price. The second

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<sup>7</sup> The five categories were corporate contracts, other long-term contracts, traditional contracts, orders against basic ordering agreements, and certain types of simplified acquisitions.



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field will indicate the month and year when the estimate or most recent purchase of the item was made. DLA initiated this change because it had determined that about 70 percent of the catalog prices were either estimates or prices from purchases made over 10 years prior.

Two other technology initiatives are designed to make price analysis easier for hardware center buyers. The first initiative is a computerized “pricing assistant” being developed to provide DLA buyers a quick way to evaluate reasonableness of offered prices. This computer program selects previously purchased items from DLA’s database that are similar to the item being considered for purchase. Using the Producer Price Index, the program escalates historical prices of the substitutable items to the proposed purchase date and provides a price comparison to the offered price to assist the buyer in determining price reasonableness. Complete system testing is expected to begin in April 2002 and DLA hopes to perform additional testing at one of its hardware centers later in 2002.

The second initiative is another computer program that enables a DLA buyer to compare an offered price for a hardware item to the latest price paid for items that have the same item name. This tool will assist the buyer in identifying the potential dollars at risk of excessive pricing and the need for additional price analyses. This program should be especially useful for first-time buys where no purchase history is available. An early version of this program is being tested at each DLA hardware center.

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## Agency Comments

DOD provided oral comments on a draft of this report and agreed with our findings.

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## Scope and Methodology

To evaluate the status of DLA’s efforts to address the problems related to spare part price increases, we reviewed DLA price trend analysis reports issued in March 2000 and March 2001 to help DOD satisfy requirements as stated in section 803(c) of the 1999 Defense Authorization Act. We also reviewed DLA PMR reports aimed at addressing the risk of overpricing. Further, we reviewed documentation that addressed the objectives and status of several DLA technological initiatives directed at helping buyers determine price reasonableness for DOD spare parts. We did not independently verify DLA data presented in the various reports and documents. However, we discussed the processes followed to attain the data and the status of initiatives with officials from the Office of the Secretary of Defense and DLA headquarters (Fort Belvoir, Virginia). We

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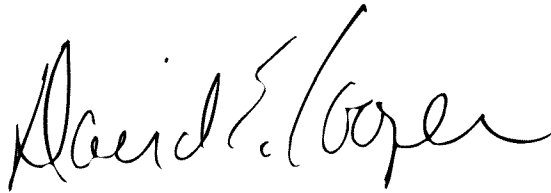
also relied on our previous reviews, as well as DOD IG reviews, for background information on the existing problems with spare part prices.

We conducted our review from June 2001 to February 2002 in accordance with generally accepted government auditing standards.

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We are sending copies of this report to the secretary of defense; the director of the Defense Logistics Agency; the secretaries of the army, navy, and air force; and the director, Office of Management and Budget. We will also make copies available to others on request.

If you have any questions on this report, please contact me or Catherine Baltzell at (202) 512-4841. Major contributors to this report were William Bricking, Cristina Chaplain, Mary Jo Lewnard, and William McPhail.

A handwritten signature in black ink, reading "David E. Cooper". The signature is fluid and cursive, with the first name "David" being the most prominent.

David E. Cooper  
Director  
Acquisition and Sourcing Management

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